Foreign Investors Stock Preference: Do barriers to international investment exist in Indonesia?

Muh Juan Suam Toro
Faculty of Economics
Universitas Sebelas Maret
Indonesia
mjuanst@yahoo.com

Abstract—The purpose of this study is to investigate the existence of barriers to international investment in Indonesia by examining whether foreign investors prefer specific firm characteristics. This research used sample from 198 active stocks traded in Indonesia Stock Exchange in 2010-2011. Regression analysis is employed to investigate the relationship of firm characteristics and foreign ownership. The result shows that foreign investors prefer firms with low dividend yield and high current ratio, meanwhile there is no evidence that foreign investors prefer large size, low leveraged, and low book to market firms. These findings imply that some information asymmetry barriers in Indonesia have reduced, meanwhile specific explicit barrier, high foreign dividend tax, still exists in Indonesia.

Keywords: barriers to international investment; foreign investor, firm characteristics; foreign ownership.

I. INTRODUCTION

Portfolio theory has motivated investors to improve portfolio performance by diversification of their assets in foreign countries. However investors will face some barriers in their effort for international investment. Stulz (1981) has documented the existence of barriers such government restriction on foreign capital flow, withholding tax, and transaction cost. Several studies have focused on phenomenon called "home bias" (Lewis, 1999; French & Poterba, 1991; Dahlquist & Robertsson, 2001) and found the existence of information asymmetry barriers. Information asymmetry exists when foreign investors have less information about the assets compared to domestic investors. Home bias occurred when investors put more weight on their home country's assets than foreign assets.

Foreign investors deal with these barriers by choosing the assets which have less information asymmetry and higher return compensate the cost emerged by these barriers. For example, Falkenstein (1996) in his study found that investors choose large firms and firms with close geographical location because large firms tend to more publicized than small firms. He also found that the closer the firm's location, the more informed and familiar the investors will be. Kang & Stulz (1997) in Japanese stock market found that foreign investors prefer larger firm size, low leveraged firms and high export ratio. Dahlquist & Robertsson (2001) using Swedish firms data found that foreign investors prefer stock with large size, high liquidity, and low debt ratio characteristics.

The rapid development of stock exchange and information technology in some developed and developing countries have reduced the barriers to international investment. Some regulations such as elimination of restriction for foreign ownership and elimination of high dividend tax rate for foreigners have been enacted especially in developed countries. French & Poterba (1991), Cooper & Kaplanis (1994), and Tesar & Werner (1995) argued that the explicit barriers can no longer explain the asset allocation especially in developed country.

Recently Indonesia has become a very attractive destination for direct international investment. Despite the political and country risk face by investors, the amount of capital inflow from foreign investors funds in Indonesia Stock Exchange has increase to $18 billion in 2012. The regulation of foreign ownership restrictions has already reduced, meanwhile the dividend tax for foreigners is still higher than for domestics. This strong evidence of Indonesia attractiveness for investment destination, contrast to existing condition of political and regulation, has lead to a question, do some investment barriers exist in Indonesia? This research aims to investigate the existence of investment barriers for foreign investors in Indonesia, more specifically, this research tries to address whether foreign investors choose certain characteristics of firm in dealing the investment barriers.

II. THEORETICAL BACKGROUND

A. Barriers to international investment

The existence of barriers to international investment has drawn attention for academic research. Dahlquist and Robertsson (2001) categorized these barriers to international investment into explicit barriers and implicit barriers. Explicit barriers include foreign exchange control, capital gain and dividend taxes, and other directly observable obstacles. Implicit barriers include political/country risks and information asymmetries.

Previous research by Stulz (1981) has focused on some explicit barriers such as governmental restrictions on foreign and domestic capital flow, foreign tax and transaction costs. These barriers caused local investors avoid foreign assets until the return on foreign assets is higher enough to compensate the cost. Foreign investors avoid their international investment if they meet problems associated with these barriers. Dahlquist & Robertsson (2001) in Japanese stock market found that investor avoid firms with high dividend yield. French & Poterba (1991), Cooper & Kaplanis (1994), and Tesar & Werner (1995) argued that explicit barriers can no longer explain the asset allocation, especially in developed market.

B. Information asymmetry and foreign investors preference

Information asymmetry has a big role in explaining foreign investors preference for specific firms. Information asymmetry is the condition that some parties have better information than other parties in transaction. Some studies documented the investors' preference for domestic stocks more than foreign stocks (Lewis, 1999; French & Poterba, 1991; and Dahlquist & Robertsson, 2001). This behavior called "home bias", that investors weight their domestic stocks higher than foreign stocks in their portfolio allocation due to investor's lack of information about foreign stocks. Coval and Moskowitz (1999) found that US investors prefer to invest in geographically closer locations. These findings suggest that investors tend to pick stocks they know more about and familiar to them. Investors prefer some firm characteristics reduce the information asymmetries.

Lin & Shiu (2003) studied foreign investors preference in Taiwanese stock market and found strong evidence the foreign investors preference for stocks with high export ratio and higher beta. Exporting firm is more publicized and the firm's products are more familiar to foreign investors. The finding that foreign investors prefer higher beta imply that investors choose stocks with higher expected return. This finding is consistent with Stulz (1981) which argued that barriers to international investment increase the transaction cost, hence the investors seek for stocks with higher return to compensate transaction cost.

Kang and Stulz (1997) examined the preference of foreign investors in Japanese stock market. They found that foreign investors choose large size and low leveraged and high export ratio firms. The information asymmetries are reduced for foreign investors in large and exporting firms because they are more publicized than small firms and foreign investors have better knowledge of exporting firms' product.

Dahlquist and Robersson (2001) study in Swedish stock markets found that foreign investors prefer large size, high liquidity and low debt ratio. High liquidity firms expressed by high current ratio are preferred because these firms reflect the strength of their financial capability. Foreign investors choose low debt ratio firms because these firms have low default ratio or low financial risk.

A study by Liljeblom et al. (2001) revealed that foreign investors do not like stocks with high dividends. This empirical result suggests that foreign investors choose to avoid stock with high dividend yield because of higher tax rate applied for foreign investors compare to domestic investor. Foreign investors prefer to retain the firm's profitability back to business to achieve higher capital gain than receiving cash dividend.

Findings on previous study of foreign investors' preference conclude that foreign investors choose stock with specific characteristics that are, large firm size, low book to market value, low dividend yield, high export ratio, high beta, high current ratio, low debt ratio, and high stock liquidity

C. Bariers to international investment in Indonesia

The rapid development of information technology in Indonesia has provided benefit for all investors to access the stock exchange data and to conduct trading activity. Indonesia stock exchange continuously improves their technology for trading mechanism to keep pace with the demand for reliable automatic trading. These developments are supported by several commercial and noncommercial website and online database that provide the updated stock exchange news and data for investors around the world. The political condition is relatively stable in Indonesia. These conditions imply that implicit barriers related to information asymmetry relatively reduced in Indonesia.

From the explicit barriers view, the restriction of foreign ownership has reduced dramatically, except ownership regulation for banks. Explicit barrier for foreign investors come from high dividend tax rate for foreign investors which is higher than domestic investor, 15% compare to 10%.

III. RESEARCH DESIGN

The data for this research is collected from the website of Indonesian Stock Exchange, www.idx.go.id for trading data and financial report, and from website of PT Kustodian Sentral Efek Indonesia (KSEI), www.ksei.co.id, for foreign ownership. This research used two years data from 2010 to 2011 for firm characteristics and foreign ownership data at the end of March 2011 and March 2012.

The selection of samples conducted in several steps, *first* eliminating financial sector stocks, *second*, eliminating stock with no foreign ownership, *third*, eliminating stock with only one year data and incomplete data, and *fourth*, *eliminating* stock with no trading activity at least a month in observation period.

Regression analysis is employed to test whether certain firm characteristics is chosen by foreign investors. The dependence variable is foreign ownership as measured by percentage of shares held by foreign investors in March 31, 2012 and March 30, 2012 for each stock to total listed shares available. The independence variable consists of six firm characteristics; firm size (SIZE), book to market value (BM), dividend yield (DY), current ratio (CR), debt ratio (DR), and stock liquidity (LIQ).

Firm size is measured by the natural log of firm's market capitalization. Book to market value is measured by dividing the book value of equity to market capitalization. Dividend yield is measured by dividing dividend per share to stock price. Current ratio is measured by dividing current asset to current liabilities. Debt ratio is measured by dividing total liabilities to total asset. Stock liquidity is measured by dividing total volume trading for a year divided to total shares available. The regression model can be expressed as follows:

$$FO_{it} = \alpha + \beta_1 SIZE_{it-1} + \beta_2 BM_{it-1} + \beta_3 DY_{it-1} + \beta_4 CR_{it-1} + \beta_5 DR_{it-1} + \beta_6 LIQ_{it-1} + \varepsilon_{it}$$

In this regression model, the dependent variable is regressed using data at t time on firm characteristics using data at t-1 time.

IV. RESULTS AND DISCUSSIONS

A. Descriptive statistics of data

The summary of descriptive statistics is shown in table 1. The final samples consist of 199 stocks in two years data.

TABLE I. DESCRIPTIVE STATISTICS

	N	Min	Max	Mean	SD
Foreign Ownership	398	0.001%	99.362%	30.539%	28.816%
Book to Market	398	0.012	7.143	0.867	0.809
Dividend Yield	398	0.000	0.322	0.015	0.030
Current Ratio	398	0.109	247.351	3.829	14.856
Debt Ratio	398	0.010	0.980	0.477	0.210
Stock Liquidity	398	0.00002	8.08402	0.45748	0.73645
Firm Size (Ln)	398	22.934	33.333	27.831	2.151

Table 1 shows that there is a firm with 99% own by foreign investors. It implies that the restriction for foreigners to invest in Indonesia has reduced. The mean value of foreign ownership is about 30% shows that firms in the samples are highly owned by foreign investors. The mean values of other data show that the samples are dominated by low book to market firms, low dividend yield, high current ratio, high stock liquidity. Domination of large size firms are shown from the mean value and standard deviation of natural logarithm of firm size.

B. Regression result

The regression model used foreign ownership as dependent variable and firm characteristic as independent variables i.e. book to market value, dividend yield, current ratio, debt ratio, stock liquidity, and firm size. The result from regression output in table II shows the adjusted R squared value at 0.035. It implies that 3.5% variation of dependent variable can be explained by independent variables. The F statistics value is significant at 0,28% that means the regression model have goodness of fit to predict dependent variable.

The t-test results in table II shows that only two firm characteristic variables considered as significant predictor of foreign ownership that is dividend yield and current ratio. The coefficient value of dividend yield has negative sign and significant at below 5% level. This result implies that the lower the dividend yield of a firm, the higher the foreign ownership will be. The coefficient value of current ratio has positive sign and significant at below 10% level. This implies that the higher the current ratio of a firm, the higher the foreign ownership will be. Lower dividend yield firms and higher current ratio firms attract foreign investors more than higher dividend yield and lower firm's current ratio.

TABLE II. REGRESSION RESULT

Predictor	Coefficient	t	Sig.
(Constant)	0.0292	0.1283	0.8980
Book to Market	-0.0175	-0.8861	0.3761
Dividend Yield	-1.6553	-3.3444	0.0009
Current Ratio	0.0018	1.7922	0.0739
Debt Ratio	-0.0103	-0.1424	0.8868
Stock Liquidity	0.0286	1.4777	0.1403
Firm Size	0.0108	1.4293	0.1537
F	3.400		0.0028
Adj. R squared	0.035		

Dependent variable: foreign ownership

Other firm characteristic variables i.e. book to market value, debt ratio, stock liquidity and firm size are not significantly predict foreign ownership. The positive sign of stock liquidity and firm size and the negative sign of book to market and debt ratio reflect, in very weak confident levels, the hypothesis that foreign investors prefer more liquid stock, larger firms, lower book to market, and lower debt ratio.

C. Discussions

The significant result of dividend yield and current ratio reflects the importance of both characteristics for foreign investors in choosing stock. Foreign investors consider firms with lower dividend yield for their investment choice caused by the avoidance for the high dividend tax. The government of Indonesia taxes foreign investors at average 15% for all foreign country, higher than domestic investors which are taxed at 10%. Foreign investors prefer to reinvest the firm profitability to achieve higher capital gain than to receive it as dividend. The high tax rate for dividend yield increasing their transaction cost that reduces their investment return. The existence of this barrier is consistent with Stulz (1981) argument that foreign tax is a form of barriers to international investment. This finding is also consistent with Lin & Shiu (2003) findings in Taiwan Stock Exchange.

Foreign investors prefer firms with higher current ratio because it reflects the financial strength of the firm. Investors face some investment risks such as country risk and firm's business risk, therefore they reduce these risks by choosing firms which have financial strength. Firms with higher current ratio have ability to cover their operation costs and ability to survive in the crisis periods. This finding is consistent with findings by Dahlquist & Robertsson (2001) that foreign investors choose firms with higher current ratio.

The reason of insignificant results of the book to market, debt ratio, stock liquidity, and firm size from the practical view implies that foreign investors do not consider these characteristics as a tool to avoid barriers for their investment. Investors consider book to market as importance firm characteristics when they have convince themselves that impact of information asymmetry barriers can be minimized by choosing firms that have ability to generate consistent high earning. Investor perceived that low book to market firms will generate higher earning than high book to market firms. Firms with lower debt ratio is not perceived as better choice for foreign investors since certain level of debt ratio is better for firms to boost their profitability. Stock liquidity appears not significant because the research samples dominated by highly liquid stocks, therefore investors perceived insignificant liquidity difference between those firms. Foreign investors are also better informed about firms in Indonesia than in the previous years, therefore the size difference is not significantly considered to reduce information asymmetry Book to market, debt ratio, stock liquidity and firm size are not significant predictors of foreign ownerships because information asymmetry in Indonesia has reduced by the development of information technology and market transparency. The reason insignificant results from the statistical view are the effect of the availability of complete data for analysis. The high variation of firms characteristics data due to limited number of complete data have lead to bias in statistical result.

V. CONCLUSION

This purpose of this study to examine the barriers to international investment in Indonesia has empirically achieved with several result. There are an evidence that foreign investors avoid explicit barriers i.e. dividend tax by choosing stock with lower dividend yield. Foreign investors also choose stock with high current ratio to reduce the country risk and business risk of the firms they have chosen.

The results also show evidences that information asymmetries faced by foreign investors have reduced in Indonesia. Foreign investors are better informed for the investment condition in Indonesia. They are no longer choosing some firm characteristics, such as large firm size, low book to market, debt ratio, and liquid stock, as a tool to minimize the impact of informational asymmetry barriers.

The results of this study imply that barriers to international investment in Indonesia mainly due to a specific government regulation, i.e. foreign dividend tax, not because there are still high information asymmetries faced by foreign investors.

Further research can be conducted by completing the research data from other source to avoid bias in statistical result. Some firm characteristic variables not examined in this study such as export ratio and market beta can be included in the next research.

REFERENCES

[1] C.H. Lin and C.Y. Shiu, "Foreign ownership in Taiwanese Stock Market," Journal of Multinational Financial Management, 13, 2003, 19-41

[2] E. Liljeblom, A. Loflund, K. Hedvall, "Foreign and domestic investors and tax induced ex-dividend day trading." Journal of Banking and Finance, vol. 25 2001, 1687-1716.

[3] E.G. Falkenstein, "Preferences for stock characteristics as revealed by mutual fund portfolio holdings. Journal of Finance 51, 1996, 111-135.

[4] I. Cooper and E. Kaplanis, E., "Home bias in equity portfolios, in#ation hedging, and international capital market equilibrium." Review of Financial Studies 7, 1994, 45-60.

[5] J.D. Coval and T.J. Moskowitz, "Home bias at home: local equity preference in domestic portfolios." Journal of Finance 54, 1999, 2045-2073.

[6] J.-K. Kang and R.M. Stulz, "Why is there a home bias? an analysis of foreign portfolio equity ownership in Japan." Journal of Financial Economics 46, 1997, 3-28.

[7] K.K. Lewis, K.K., "Trying to explain home bias in equities and consumption." Journal of Economic Literature 37, 1999, 571-608.

[8] K.R. French and J.M. Poterba, "Investor diversification and international markets." American Economic Review 81, 1991, 222-226.

[9] L. Tesar and I Werner, "Home bias and high turnover." Journal of International Money and Finance 14, 1995, 467-493.

[10] M. Dahlquist, and G. Robertsson, "Direct foreign ownership, institutional investors, and firm characteristics, Journal of Financial Economics, vol. 59, 2001, 413-440.

[11] R.C. Merton, "A simple model of capital market equilibrium with incomplete information." Journal of Finance 42, 1987, 483-510.

[12] R.M. Stulz, "On the e!ects of barriers to international investment." Journal of Finance 36, 1981, 923-934.